

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #95-39**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether [THE TAXPAYER], will be classified as a financial institution for corporate franchise, excise tax purposes and if so, the manner in which it will be required to file its franchise, excise tax returns.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;

- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

[CORPORATION A] is a publicly held corporation which is incorporated under the laws of Tennessee and commercially domiciled in Tennessee. [CORPORATION A] holds the stock of approximately [NUMBER] subsidiaries which are also incorporated under the laws of Tennessee and have operations in Tennessee and various other states. [CORPORATION A] is a [TYPE OF BUSINESS] driven [TYPE OF BUSINESS - NOT FINANCIAL INSTITUTION] management company that acquires and operates multi-specialty [TYPE OF BUSINESSES - NOT FINANCIAL INSTITUTIONS] and develops and manages independent [TYPE OF BUSINESS] associations. [CORPORATION A'S] subsidiaries form corporate alliances with the [TYPE OF BUSINESS] organizations whereby [CORPORATION A'S] subsidiaries provide capital items, management services and other business resources needed by the [TYPE OF BUSINESS] organizations. [CORPORATION A] provides management services to its subsidiaries which include consulting on operational matters and support in the areas of accounting, human resources, legal, insurance and cash management. A management fee is paid by the subsidiaries to [CORPORATION A] in exchange for these services. In addition, [CORPORATION A] currently provides market term financing to its subsidiaries. The subsidiaries themselves do not make loans, but may use money borrowed from [CORPORATION A] to provide capital items to [TYPE OF BUSINESS] organizations with which they have corporate alliances.

[THE TAXPAYER] is a wholly owned subsidiary of [CORPORATION A] and has no subsidiaries of its own. [THE TAXPAYER] is legally and commercially domiciled in Tennessee. In order to segregate the financing functions from the [TYPE OF BUSINESS] management activities, [CORPORATION A] is considering converting [THE TAXPAYER] into an affiliated finance company by consolidating the intercompany financing activities of [CORPORATION A'S] affiliated group within [THE TAXPAYER]. Under this plan, neither [CORPORATION A] nor any of its subsidiaries, except [THE TAXPAYER], will make loans. Thus, [THE TAXPAYER] will be the only member of the group making loans. The intercompany notes receivable held by [THE TAXPAYER] will be primarily long term in nature and will be either unsecured notes or notes secured by tangible property. The debtor subsidiaries will include certain subsidiaries commercially and legally domiciled in Tennessee and other subsidiaries commercially domiciled outside Tennessee.

[THE TAXPAYER]'s sole continuing business operations will involve providing debt financing to [CORPORATION A'S] subsidiaries. [THE TAXPAYER] will make loans

to and collect interest and principal payments from affiliate customers located both within and without Tennessee. The loan proceeds borrowed from [THE TAXPAYER] will be put into use by [CORPORATION A'S] subsidiaries in Tennessee and in other states to fund acquisitions, to fulfill their working capital needs, and to fund capital expenditures, [TYPE BUSINESS - NOT FINANCIAL INSTITUTION] mergers and debt refinancing.

Employees of [THE TAXPAYER] will conduct most of its business from an office located in Tennessee. [THE TAXPAYER]'s management will make investment decisions with respect to borrowing additional capital, extending funds to [CORPORATION A'S] affiliates in the form of long term debt, and collecting interest and loan repayments in connection with its loans to [CORPORATION A'S] affiliates. [THE TAXPAYER]'s employees will monitor the cash flow needs of [CORPORATION A'S] subsidiaries, evaluate their credit worthiness and decide whether and under what terms to provide debt financing. All of [THE TAXPAYER]'s payroll will be paid to Tennessee employees and all of its property will be physically located in Tennessee.

QUESTIONS

1. Will [THE TAXPAYER] be considered a financial institution for Tennessee franchise and excise tax purposes?
2. If [THE TAXPAYER] is considered a financial institution for Tennessee franchise and excise tax purposes, will it be required to file a combined franchise and excise tax return and, if so, which entities will be included in the combined return?
3. Will [THE TAXPAYER] be required to apportion its capital base for Tennessee franchise tax purposes and its income for Tennessee excise tax purposes?
4. What interest earned by [THE TAXPAYER] on secured and unsecured intercompany debt will be sourced to the Tennessee receipts factor numerator for franchise and excise tax purposes?

RULINGS

1. Yes.
2. No.
3. Yes.
4. Interest on secured debt will be sourced to Tennessee if the underlying collateral is located in Tennessee. Interest on unsecured debt will be sourced to Tennessee if the loan proceeds were applied in Tennessee. If it can not be determined where the funds were

applied, the interest will be attributed to Tennessee if the business first applied for the loan in Tennessee .

ANALYSIS

1. [THE TAXPAYER] IS A FINANCIAL INSTITUTION

For Tennessee franchise, excise tax purposes, T.C.A. § 67-4-804(a)(7) defines a financial institution as follows:

“Financial institution” means a holding company, any regulated financial corporation, a subsidiary of a holding company or regulated financial corporation, *or any other corporation organized under the laws of the United States or any other taxing jurisdiction that is carrying on the business of a financial institution.* However, “financial institution” does not include insurance companies subject to tax under §§ 56-4-201 - 56-4-214. (Emphasis Added)

According to T.C.A. § 67-4-804(a)(2)(A)(iii) and (iii)(e) and (h), the “business of a financial institution” includes the following:

Otherwise making, acquiring, selling or servicing loans or extensions of credit including, but not limited to, the following:

Secured or unsecured commercial loans of any type;

Any other transactions of comparable economic effect;

Although [THE TAXPAYER] will not be a bank or “regulated financial corporation” as defined in T.C.A. § 67-4-804(a)(11), it will be making secured and unsecured loans to corporations within its affiliated group. These loans will be made to business organizations and therefore are commercial loans or transactions having comparable economic effect to commercial loans. Thus, [THE TAXPAYER] is a corporation carrying on the business of a financial institution and our statutes define such a corporation as a financial institution.

2. [THE TAXPAYER] IS NOT REQUIRED TO FILE A COMBINED RETURN

T.C.A. § 67-4-805(a)(3), quoted below, and T.C.A. § 67-4-914(c), quoted in part below, require certain types of unitary businesses to file combined franchise, excise tax returns.

For a unitary business, as defined in § 67-4-804(a)(13) [now § 67-4-804(a)(16)], “net earnings” is defined as the combined net earnings as defined in subdivision (a)(1) for all members of the unitary group with dividends, distributions and receipts

from transactions between members of the unitary group excluded, and subject to adjustments in subsection (b) on a combined basis.

Financial institutions which form a “unitary business” as defined in § 67-4-804(a)(13) [now § 67-4-804(a)(16)], shall file a combined return and pay tax on all operations of the unitary business.

T.C.A. § 67-4-804(a)(16) defines a “unitary business” as follows:

“Unitary business” means business activities or operations of financial institutions that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. “Unitary Business” may be applied within a single legal entity or between multiple entities. “Unitary group” includes those entities that are engaged in a unitary business wholly within or within and without this state.

T.C.A. §§ 67-4-805(a)(3) and 67-4-914(c) require combined franchise, excise tax returns only from unitary businesses. Under T.C.A. § 67-4-804(a)(16), only financial institutions can be unitary businesses for corporate franchise, excise tax purposes. Except for [THE TAXPAYER], [CORPORATION A] and its approximately [NUMBER] subsidiaries are [TYPE OF BUSINESS - NOT FINANCIAL INSTITUTION] management and [TYPE OF BUSINESS - NOT FINANCIAL INSTITUTION] organizations. None of the businesses in the group except [THE TAXPAYER] are defined as financial institutions under our law.

[THE TAXPAYER] will be required to file its Tennessee corporate franchise, excise tax returns as a financial institution. Since it is the only financial institution in the group, [THE TAXPAYER]’s franchise, excise tax returns will not be filed on a combined basis. The returns will be filed on a separate entity basis and will reflect only the business operations of [THE TAXPAYER].

3. [THE TAXPAYER] WILL BE PERMITTED TO APPORTION FOR
FRANCHISE, EXCISE TAX PURPOSES

Under the facts presented, [THE TAXPAYER] will be making loans to subsidiaries in its affiliated group. Some of [THE TAXPAYER]’s customers will be commercially and legally domiciled in Tennessee and some will be commercially domiciled in other states. Although the facts presented do not describe the specific details of the loan transactions in which [THE TAXPAYER] plans to engage, it is stated that [THE TAXPAYER] will make loans to and collect interest and principal payments from customers in other states. Under the financial institution nexus criteria set forth in T.C.A. §§ 67-4-806(d) and 67-4-903(f), [THE TAXPAYER] will be regularly engaging in transactions with customers outside Tennessee that involve intangible property, including loans, and such transactions

will result in receipts flowing to the taxpayer from within other states. Thus, [THE TAXPAYER] will be doing business both within and without Tennessee.

T.C.A. §§ 67-4-815(a) and 67-4-919(a) make the following provisions:

A financial institution which is not filing a combined return and which has earnings from business activity both within and without this state shall apportion its business earnings by multiplying such earnings by the quotient of the institution's total receipts attributable to the transaction of business in Tennessee, as determined under subsection (d), divided by the institution's total receipts attributable to transacting business in all taxing jurisdictions, as determined under subsection (d).

Notwithstanding any other provision of this part, a financial institution which is not filing a combined report and which has business activity both within and without Tennessee and which is paying tax based on the value of its issued and outstanding stock, surplus and undivided profits shall apportion its tax base to Tennessee by multiplying the tax base by the quotient of the institution's total receipts attributable to the transaction of business in Tennessee, as determined under subsection (d), divided by the institution's total receipts attributable to transacting business in all taxing jurisdictions, as determined under subsection (d).

[THE TAXPAYER] is a financial institution with business activities both within and without Tennessee. Under Tennessee law it will apportion its net worth and net earnings by use of a gross receipts apportionment formula.

4. SOURCING OF [THE TAXPAYER]'S INTEREST INCOME

[THE TAXPAYER] will be making both unsecured loans and loans secured by tangible property. T.C.A. § 67-4-815(d)(2)(A), (B) and (d)(4) and 67-4-919(d)(2)(A), (B) and (d)(4) make the following provisions concerning sourcing of interest from secured and unsecured commercial loans for purposes of the gross receipts franchise, excise tax apportionment formula used by financial institutions:

Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property shall be attributed to Tennessee if the security or sale property is located in Tennessee. If any part of the sale property or property standing as security for the payment of the debt is located part within and part without the state, only such proportion of the interest income or other receipts shall be attributed to Tennessee as the value of the property within the state bears to the whole property;

"Value" means only that value which the property would command at a fair and voluntary sale. Value shall be determined at the time the loan is made and shall

not vary from year to year. In the event additional real or tangible personal property is pledged as security or otherwise covered under a loan or installment sales contract after the time the loan is made, the ratio based on the value of the property in the state compared to the whole property shall be adjusted;

Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property shall be attributed to Tennessee if the proceeds of the loan are to be applied in Tennessee. If it cannot be determined where the funds are to be applied, the receipts are to be attributed to the state in which the business applied for the loan. As used in this subdivision, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first. For attribution purposes, "loan" does not include demand deposit clearing accounts, federal funds, certificates of deposit, and other similar wholesale banking instruments issued by other financial institutions;

Under Tennessee law, interest earned by [THE TAXPAYER] on a commercial loan secured by tangible property will be sourced to Tennessee for purposes of the franchise, excise tax gross receipts apportionment formula numerator based on the location of the property that serves as security for the loan. If the property securing the loan is located in Tennessee, all the interest income earned on the loan will be included in [THE TAXPAYER]'s apportionment formula numerator. If part of the property securing a loan is located in Tennessee and part is located outside Tennessee, interest income from that loan will be attributed to Tennessee based on the proportionate value of such property in Tennessee as to the value of the property everywhere. For this purpose, T.C.A. §§ 67-4-815(d)(2)(B) and 67-4-919(d)(2)(B) define "value".

[THE TAXPAYER]'s interest income from unsecured loans will be sourced to Tennessee if the loan proceeds are applied in Tennessee. For example, if funds borrowed from [THE TAXPAYER] are used to acquire a facility located in Tennessee or to make a capital expenditure for property located in Tennessee, the interest on the loan will be sourced by [THE TAXPAYER] to Tennessee regardless of the domicile or location of the subsidiary making the acquisition or capital expenditure. In the event unsecured loan proceeds are used by a subsidiary doing business wholly within Tennessee to fulfill its working capital needs or to refinance debt, [THE TAXPAYER] will source the loan interest to Tennessee. When unsecured loan proceeds are used to fund [TYPE OF BUSINESS] mergers in Tennessee, the interest on the loan will be sourced to Tennessee.

However, in cases where a subsidiary doing business both within and without Tennessee uses an unsecured loan to fund its working capital needs or to refinance debt, or where the loan is used to fund multistate [TYPE OF BUSINESS] mergers and some of the merging parties are located both within and without Tennessee, it may be impossible to determine how much, if any, of the loan proceeds were applied in Tennessee. In the event it can not be determined where the loan proceeds are applied, Tennessee law attributes the interest income to the state in which the subsidiary applied for the loan.

For this purpose, “applied for” means initial inquiry, including customer assistance in preparing the loan application, or submission of a completed loan application, whichever occurs first. If the subsidiary debtor first made initial inquiry about the loan in Tennessee and later submitted his completed loan application, [THE TAXPAYER] will source the interest on the loan to Tennessee regardless of where the loan application was later submitted. If, prior to making inquiry about the loan, the debtor subsidiary submitted his completed loan application in Tennessee, [THE TAXPAYER] will source the loan interest to Tennessee.

Arnold B. Clapp, Tax Counsel

APPROVED:_____
Ruth E. Johnson, Commissioner

DATE: 11-8-95